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In the Supreme Court of the United States

OCTOBER TERM, 1934

No. 6

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, petitioner

v.

SUSAN DWIGHT BLISS

ON A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the Board of Tax Appeals (R. 16–20) are reported in 27 B.T.A. 205. The opinion of the Circuit Court of Appeals for the Second Circuit (R. 26) is reported in 68 F. (2d) 890.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered January 15, 1934 (R. 31). A petition for a writ of certiorari was filed on March 23, 1934,

and was granted April 30, 1934. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Where the taxpayer elects to be taxed under Section 101 (a) of the Revenue Act of 1928, does the basis for computing the 15% deduction allowable for charitable contributions under Section 23 (n) of the Act include capital net gains, or is it limited to ordinary net income only?

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in Appendix A, *infra*, pp 27–34.

STATEMENT

This is a proceeding for the redetermination of deficiencies in income taxes for the years 1928 and 1929. It was begun by notice of deficiency sent to the taxpayer by the Commissioner of Internal Revenue relating to certain deductions not here material. (R. 2, 9.) By amended answers to the taxpayer's petitions to the Board of Tax Appeals, the Commissioner set forth as an additional ground for assessment of deficiencies that the taxpayer, having elected to be taxed under Section 101 (a) of the Revenue Act of 1928, had claimed deductions for charitable contributions in excess of the 15% of her net income allowed by Section 23 (n) of the Act. (R. 7–8, 12–13.)

The facts were stipulated, and as so stipulated may be summarized as follows (R. 13–15):

The amount of charitable and other contributions made by the taxpayer during the years 1928 and 1929 of a character deductible from net income, subject to the limitations provided in Section 23 (n) of the Revenue Act of 1928 (*infra,* p. 28) was $43,995.92 for the year 1928 (R. 14), and $39,088.46 for the year 1929 (R. 15). The ordinary net income of the taxpayer before deducting the amounts of such contributions was $270,490.77 for the year 1928 (R. 14) and $247,571.83 for the year 1929 (R. 15). The taxpayer's capital net gain for 1928 was $211,544.82 (R. 14), and for 1929 was $299,942.31 (R. 15).

The taxpayer deducted the respective total amounts of the charitable and other contributions from the respective years' gross income upon the ground that in determining the 15% limitation for charitable deductions under Section 23 (n) of the 1928 Act, ordinary income and capital net gains should both be included, regardless of her election to be taxed under Section 101 (a) of the Act.

The Commissioner took the position that deductions for contributions should be limited to 15% of the "ordinary net income", excluding "capital net gains", by virtue of the election to be taxed under Section 101 (a). (R. 8, 12–13.) In this he was sustained by the Board of Tax Appeals. (R. 19.) The Circuit Court of Appeals reversed, Judge Learned Hand dissenting. (R. 26–31.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In allowing the taxpayer, for the years 1928 and 1929, to deduct charitable contributions under Section 23 (n) of the Revenue Act of 1928 to the extent of 15% of the sum of her ordinary net income plus her capital net gains.

2. In reversing the Board of Tax Appeals.

SUMMARY OF ARGUMENT

The taxpayer elected to have her capital net gains taxed under Section 101 (a) of the Revenue Act of 1928 (*infra*, p. 28) rather than in the normal manner. Under that section the taxpayer is given the option of having his capital net gain segregated from his ordinary net income and taxed at a flat 12½% rate. Where a taxpayer exercises this option, his total net income is divided into two separate clases: capital net gains and ordinary net income. These two classes are computed separately and taxed separately, at different rates. The controversy in this case is over the computation of taxpayer's ordinary net income.

"Ordinary net income" is defined in Section 101 (c) (7) to mean "the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions." Since, under the plain language of the statute, capital items are to be excluded, they may not be included for the purpose of determining the allowance for charitable con-

tributions, which is one of the ordinary deductions entering into the computation of ordinary net income.

Where Section 101 (a) is invoked, it was the intent of Congress that the two types of income should be completely segregated and that items coming within one class should not influence the computation of the tax on the other class. The 15% limitation for contribution deductions should consequently not be affected by capital net gains. This purpose of segregation is clearly evidenced by the language of the capital gain provisions and their legislative history.

When the election is made to be taxed under Section 101 (a) there is an exception to the general limitation provided by Section 23 (n), and the otherwise general meaning of "net income" becomes modified to mean the taxpayer's "ordinary net income" as used in Section 101 (c). Thus Section 101 (a) is a specific provision dealing with particular situations, and must be interpreted as prevailing over the general language used elsewhere.

Where by invoking the capital net gain provisions the taxpayer succeeds in having his capital gains taxed separately, thereby effecting a substantial reduction in his tax, he should not be heard to complain that his ordinary deductions are somewhat reduced because of the separate computation. He may not have his tax reduced by invoking the rule of segregation and at the same time seek a further reduction on the theory that segregation

should be ignored. He may not exclude capital net gains for the purpose of securing the benefit of a lower rate of tax, and at the same time include capital gains for the sole purpose of securing the maximum deduction for contributions.

Section 101 (b) of the Act (*infra*, pp. 28–29) provides that where a taxpayer sustains a capital net loss, such net loss is to be segregated from ordinary items of net income, and the tax is to be based upon this ordinary net income minus 12½% of the capital net loss. The court below recognized that this section where applicable treats capital net losses in the same manner as Section 101 (a) treats capital net gains. Unless the theory of segregation is applied, it means that taxpayers who have capital net losses may have a net income for the purpose of computing the ordinary tax liability, and at the same time have no net income for the purpose of computing the amount allowable as a deduction for contributions—a conclusion that seems to be at variance with the evident intent of the statute.

ARGUMENT

For the year 1928[1] the taxpayer made charitable contributions aggregating $43,995.92. Such contributions are deductible under Section 23 (n) of the Revenue Act of 1928 (*infra*, p 28) "to an amount which * * * does not exceed 15 per centum of the taxpayer's *net income* as computed

[1] The year 1929 is also involved but the figures for the year 1928 will suffice for illustration.

without the benefit of this subsection." (Italics supplied.) The ordinary net income of the taxpayer before deducting the amount of such contributions was $270,490.77. The capital net gain for such year was $211,544.82. The court below gave the taxpayer the right to deduct charitable contributions to the extent of 15% of the sum of her ordinary net income plus her capital net gain; that is, to the extent of 15% of $482,035.59. It is the Government's position that by virtue of taxpayer's election to be taxed under Section 101 (a) of the 1928 Act (*infra,* p. 28), her deduction for charitable contributions is limited to 15% of her ordinary net income, excluding her capital net gains.

It must be conceded that had the taxpayer elected to be taxed in the normal manner, she would clearly be entitled to the full deduction as allowed by the court below, because "net income" as used in Section 23 (n) (*infra,* p. 28), and as defined in Section 21 (*infra,* p. 28), is broad enough, if unqualified, to cover "capital net gains." But instead of being taxed in the normal manner, the taxpayer elected to be taxed under the "capital net gain" provisions, which prescribe an entirely different method of taxation. Under this method a taxpayer's total net income is divided into two separate classes: capital net gains and ordinary net income. These two classes are computed separately and taxed separately, at different rates.

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This departure from the normal method of taxation is set forth in Section 101 (a) of the Act, which provides:

> *Tax in case of capital net gain.*—In the case of any taxpayer, other than a corporation, who for any taxable year derives a capital net gain (as hereinafter defined in this section), there shall, *at the election of the taxpayer,* be levied, collected, and paid, *in lieu of all other taxes imposed by this title,* a tax determined as follows: a partial tax shall first be computed upon the basis of the *ordinary net income* at the rates and in the manner as if this section had not been enacted and the total tax shall be this amount plus 12½ per centum of the capital net gain. [Italics supplied.]

It is to be noted that under this section instead of applying normal and surtax rates to "net income" as defined in Section 21, the said rates are applied to "ordinary net income." A partial tax is *first* to be computed on *ordinary net income,* and the total tax is this amount plus 12½% of the capital net gain.

There is no dispute in this case over the 12½% tax on the taxpayer's capital net gain; the controversy is over the amount of the taxpayer's "ordinary net income." The question is whether, in computing "ordinary net income", charitable contribution deductions are to be allowed to the extent of 15% of the taxpayer's ordinary net in-

come plus her "capital net gains", or to the extent, only, of 15% of her "ordinary net income."

"Ordinary net income" is defined by Section 101 (c) (7) of the Act as meaning—

> * * * the net income, computed in accordance with the provisions of this title, after *excluding all items of capital gain, capital loss, and capital deductions.* (Italics supplied.)

It seems to us, just as it appeared to Judge Learned Hand, who dissented from the opinion of the court below (R. 30–31), and to Judge Morton, who dissented in *White* v. *Atkins* (C.C.A. 1st), decided March 14, 1934, 69 F. (2d) 960, that the above language is " too plain for latitude of interpretation " (R. 30). Congress commanded that in the computation of " ordinary net income " all capital gains, capital losses, and capital deductions should be excluded. Since these items must be *excluded* in the computation, then clearly they may not be *included,* even for the purpose of computing the charitable contribution deduction, which is one of the ordinary deductions entering into the computation of " ordinary net income."

As pointed out in the dissenting opinion below (R. 30–31), Section 23(n) puts a limit upon charitable gifts of "15 per centum of the taxpayer's net income *as computed without the benefit of this subsection.*" This section requires two computations: first, a computation of net income, omitting all charitable gifts. That gives a tentative net in-

come, or a basis for computing charitable deductions; all charitable gifts may then be deducted until they reach the prescribed limit, which is 15% of the basis first computed. Thus the final taxable income is computed in two steps.

The problem here is to determine "ordinary net income." "Ordinary net income" is to be "computed in accordance with the provisions of this title" (Sec. 101 (a) (7)), which, as regards charitable gifts, means that two steps must be taken: first, the determination of the basis upon which to compute the charitable contribution deductions; second, the deduction of the gifts to the extent of 15% of such basis. However, "ordinary net income" is to be computed only after excluding capital items—and "excluding" must necessarily relate to the computation of the basis as well as to the final computation. It would be very unreal to suppose that "excluding" meant that the capital items were first to be included in the computation of the basis; that after they had been included, and 15% of the net result deducted, the same items should be reversed—the gains subtracted and the losses added. That would not be "excluding" them from the computation; "excluding" means dealing with them once and for all.

We submit that the decision below not only ignores the plain language of the statute defining "ordinary net income", but violates the plain purpose of Congress that when an election is made to be taxed under Section 101 (a), all capital items

should be segregated completely from ordinary items of income. The capital items form one distinct class; the ordinary net income items constitute an entirely different class. The tax on these two classes is computed separately, at different rates. It was not intended under this theory of segregation that items of one class should affect the computation of the tax on the other. This purpose of Congress is clearly shown by the above definition of "ordinary net income", which requires that all items of capital gains, capital losses, and capital deductions be excluded in making the computation.

This purpose is further shown from the definition of "capital net gain" in Section 101 (c) (5) (*infra*, p. 29). That subdivision provides that—

> "Capital net gain" means the excess of the total amount of *capital gain* over the sum of (A) the *capital deductions* and *capital losses*, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gains.

"Capital gain", as defined in Section 101 (c) (1), is an item that, except for the capital gain provisions, would fall within the broad meaning of "gross income" as defined in Section 22 (*infra*, p. 27). "Capital loss" and "capital deductions" as defined in subdivisions (2) and (3), respectively, of Section 101 (c), are items that, except for Section 101 (a), would fall within the ordinary deductions specified in Section 23 (*infra*, p. 28). These

various items ordinarily enter into the computation of net income under Section 21 (*infra*, p. 27), but when Section 101 (a) is invoked, these capital items are eliminated and given separate classifications. Thus it is entirely clear that under the method prescribed in Section 101 (a) two classes of income are set up: all items of ordinary net income are set up in one class, and taxed at normal and surtax rates; and all capital items, eliminated from ordinary net income, are separated into another class and taxed at a flat 12½% rate.[2] The intent is clear that items in one class are not meant to affect, or figure in the computation of, the tax on another class. No items of ordinary income or deductions enter into the computation of capital net gain; and, conversely, capital items are specifically excluded in computing the ordinary net income.

This purpose of complete segregation is further shown by the provision in Section 101 (c) (5), that where the ordinary deductions exceed ordinary gross income, this difference (or ordinary net loss) shall go to reduce the capital net gain. Even in that case this ordinary net loss is limited to the amount by which the ordinary deductions (excluding capital losses and capital deductions) exceed the gross income "computed without including cap-

[2] The tax returns prescribed by the Internal Revenue Bureau make provision, where the election is exercised, for the separate reporting of these two classes of income, and for the separate computation of the tax thereon.

ital gains"—again showing the complete severance of capital items from ordinary items of income.

In further support of this purpose is Section 101 (d) (*infra,* p. 30), which provides:

> The total tax determined under subsection (a) or (b) shall be collected and paid in the same manner, at the same time, and subject to the same provisions of law, including penalties, as other taxes under this title.

There would be no need to add this provision if the tax on capital net gains was, in the mind of Congress, anything but a separate tax.

That it is an entirely separate tax is also shown by the ruling that the personal exemption allowed by Section 25 of the 1928 Act is not applicable to reduce the tax on capital net gains. Indeed, the discrimination shown by Congress in allowing the credits under Section 131 to apply against the capital gain tax, while those under Section 25 do not so apply, is significant. See Article 501, Regulations 74, *infra,* p. 31.

That Congress intended a complete segregation of the two types of income is further shown by the legislative history of the capital net gain provisions, which appeared for the first time in the Revenue Act of 1921. This segregation theory was urged upon Congress in testimony before the Congressional committees. For the convenience of the Court the pertinent parts of these Committee Hearings are set forth in Appendix B (*infra,* pp.

35–38). That this theory of complete segregation was adopted by Congress when the 1921 Act was passed is shown by the 1921 Revenue Bill (H.R. 8245) in its various forms, by the Reports of the House Ways and Means Committee and the Senate Finance Committee, and by the Conference Report on the bill, which are set forth in Appendix C (*infra,* pp. 39–43). From these reports it will be seen that Congress recognized that the gain on the sale of a capital asset, since it represents increment over a series of years, is unlike ordinary income earned within the current taxable year, and because of this difference it proposed to tax the two types of income in an entirely different manner. Instead of ignoring capital gains entirely, as in Great Britain (See S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12–13, *infra,* p. 41), the purpose was to segregate the capital transactions from ordinary transactions and to tax them separately, at different rates.

This theory of segregation was recognized by the Circuit Court of Appeals for the Fifth Circuit in *Westfeldt* v. *Commissioner,* 63 F. (2d) 882. There it was held that where an individual on a calendar-year basis sustains a capital net loss in 1924 and reports income from a partnership having a fiscal year ended in 1924, the amount to be placed in the lower brackets of the rate schedule applicable to 1924, under Section 207 (b) of the Revenue Act of 1924 (*infra,* p. 30) is the amount of his ordinary net income, undiminished by any part of the capital net loss. The court recognized the

principle of segregation, and, after discussing the capital net gain and capital net loss provisions, said (p. 883):

> * * * the capital items thus put under the 12½% flat rate go out of the computation of the taxes under the regular rates, and the "other income" to which partnership gains are to be added is unaffected by the capital items.

We submit that in view of the plain language of the statute, and considering the legislative history of the provisions involved, Congress intended the two types of income should be completely segregated; that items coming within the one class should not influence the computation of the tax on the other class; and that the 15% limitation on contribution deductions must be computed solely with reference to ordinary net income, "excluding all items of capital gain, capital loss, and capital deductions." (Section 101 (c) (7).)

It is true that in computing the 15% limitation on charitable deductions, Section 23 (n) allows 15% of the "net income" (which except for Section 101 (a) would include capital net gain). But that provision is general and appeared in the revenue laws before the specific capital gain provisions here involved were enacted.[3] The capital gain provisions

[3] The 15% limitation on contribution deductions first appeared in Section 214 (a) (11) of the Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1068), whereas the capital gain provisions made their first appearance in Section 206 of the Revenue Act of 1921 (c. 136, 42 Stat. 227, 232).

made a basic change in the method of computing and reporting taxable income. These provisions are not operative in all cases, but only in those instances where the taxpayer elects to avail himself thereof. Where the taxpayer elects to be taxed by the orthodox method, the orthodox definition of "net income" applies; but where the new method is chosen, the specific provisions dealing with the particular situation must be interpreted as prevailing over the general language elsewhere. *Townsend* v. *Little,* 109 U.S. 504, 512; *Rodgers* v. *United States,* 185 U.S. 83, 88, 92; *Kepner* v. *United States,* 195 U.S. 100, 125. Where the specific capital gain provisions are invoked, there is an exception to the general limitation provided by Section 23 (n), and the otherwise general meaning of "net income" becomes modified to mean the taxpayer's "ordinary net income" as defined in Section 101 (c) (7). "Ordinary net income" is "net income" as defined in Section 21, with only this difference: that all capital items are eliminated, and taxed separately. "Ordinary net income" becomes the taxpayer's net income for the specific purpose of computing the ordinary tax liability. Sections 11 and 12 of the 1928 Act (*infra,* p. 27) levy a normal tax and a surtax on the taxpayer's "net income", but where the capital gain provisions are applied, "net income" as used in those sections is taken to mean "ordinary net income." Correspondingly, "net income" as used in Section 23 (n) and elsewhere

in the Act is also to be taken as referring to "ordinary net income." The significant thing is that under this method "net income" as defined in Section 21 disappears and its place is taken by "ordinary net income."

It cannot be said, therefore, that merely because no change was made in the general language of the statute when the capital gain provisions were enacted, such provisions were not intended to effect a change. Admitting that there is no change where the taxpayer does not elect to come under the capital gain provisions, yet where he elects to be taxed thereunder he should take the burdens, whatever they are, with the benefits. Here, by invoking the capital net gain provisions and having her capital gains taxed separately, the taxpayer has effected a saving of over $25,000.[4] She should not, therefore, be heard to complain that her ordinary deductions are somewhat reduced because of the separate computation. As pointed out by Judge Morton in his dissenting opinion in *White*

[4] It will be remembered that the taxpayer's ordinary net income for the year 1928 was $270,490.77, while her capital net gain was $211,544.82, thus throwing her income into the higher surtax brackets. The normal tax and the surtax on these capital net gains, had they been included in the ordinary net income and taxed in the regular manner, would have been 25% of such capital net gains. Sections 11 and 12 of the 1928 Act (*infra*, p. 27). Under the capital net gain provisions the tax on such net gains is only 12½%. Thus, in exercising her option to be taxed under Section 101 (a), taxpayer has cut the tax on such gains to the extent of approximately $25,000.

v. *Atkins, supra,* the taxpayer cannot *exclude* capital gain from gross income for the purpose of getting the lower rate thereon and at the same time *include* capital gain in gross income for the purpose of computing the maximum deduction for contributions.

That we are correct in our position is clearly demonstrated, we submit, when we consider the case of a capital net loss. Section 101 (b) of the 1928 Act (*infra,* p. 28) provides that where a taxpayer has sustained a capital net loss—

> * * * there shall be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted, and the total tax shall be this amount minus 12½ per centum of the capital net loss; but in no case shall the tax of a taxpayer who has sustained a capital net loss be less than the tax computed without regard to the provisions of this section.

It will be noted that this section, where applied, treats capital net losses in the same manner that Section 101 (a) treats capital net gains. Had the taxpayer in this case sustained a capital net loss of $200,000, and had she an ordinary net income of $200,000 (before deducting her contributions), it would seem altogether clear that such capital net loss, being segregated under Section 101 (b) from ordinary net income, should not figure in the

computation of the contribution deductions under Section 23 (n). If the capital net losses were not separated from the ordinary net income, it would mean that the taxpayer, for the purpose of computing the ordinary tax, would have an ordinary net income of $200,000, subject to the normal rates, and at the same time have no net income for the purpose of computing the amount allowable as a deduction for contributions. However, it seems entirely clear to us that, consistently with the treatment of capital net gains,[5] capital net losses should be segregated entirely from ordinary net income, and that in the supposed case the allowance for contribution deductions should be computed with reference to the ordinary net income, excluding all consideration of capital net losses. The Board of Tax Appeals so held in *Elkins* v. *Commissioner,* 24 B.T.A. 572, and Judge Morton in his dissenting opinion in *White* v. *Atkins, supra,* thought that the reasoning of the *Elkins* case was unanswerable.

The various decisions on this question present a number of conflicting views. The first decision in point is that of *Elkins* v. *Commissioner, supra,* which arose in connection with the capital net loss provisions. That decision is in conformity with the position taken by the Government in this case. It was followed by the Board in the case of *Livingood*

[5] The court below, as well as the First Circuit in *White* v. *Atkins*, *supra*, thought that the same treatment should be accorded capital net losses as is accorded capital net gains.

v. *Commissioner,* 25 B.T.A. 585, which also dealt with a capital net loss. The first case dealing with a capital net gain was *Harbison* v. *Commissioner,* 26 B.T.A. 896 (reversed, 68 F. (2d) 1004 (C.C.A. 2d)). There the Board followed the principle of segregation as recognized in the *Elkins* decision and held that the base for contribution deductions under Section 23 (n) was ordinary net income, excluding capital net gains. This decision was followed by the Board in *Colgate* v. *Commissioner,* 27 B.T.A. 506 (reversed, C.C.A. 2d, unreported), and in the instant case, 27 B.T.A. 205, in both of which cases the principle was recognized.[6]

But the Board changed its position, and in *Straus* v. *Commissioner,* 27 B.T.A. 1116, on identical facts, held that capital net gains should be included in the base for computing contribution deductions.[7] The later cases on the question all follow largely the reasoning of the Board in the *Straus* case.[8]

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[6] The *Harbison* and *Colgate* cases are now pending on writs of certiorari in this Court, Nos. 7 and 8, respectively, October Term, 1934.

[7] The *Straus* case is now pending after argument, on the Commissioner's appeal, in the Court of Appeals for the District of Columbia.

[8] *Robinette* v. *Commissioner,* 27 B.T.A. 1426, now pending after argument in the Circuit Court of Appeals for the Third Circuit; *Igleheart* v. *Commissioner,* 27 B.T.A. 1426, now pending after argument in the Circuit Court of Appeals for the Seventh Circuit; *Woodward* v. *Commissioner,* 27 B.T.A. 1426, now pending on appeal to the Circuit Court of Appeals for the Second Circuit; *Blow* v. *United States*

Following the suggestion of the Board in the *Straus* case, the decision below is predicated largely upon the proposition that the obvious purpose of Section 23 (n) was to encourage gifts for charity and the like, and that there is nothing in the capital gain provisions to indicate that taxpayers were intended to lose any part of the deduction allowed by Section 23 (n). However, it is submitted that the Revenue Act of 1921 made a distinct change in the method of reporting and computing taxable income. That Act introduced a distinction not theretofore recognized in income taxation between ordinary income and a profit on the sale of a capital asset, which, as Judge Morton pointed out in his dissenting opinion in *White* v. *Atkins, supra,* is not income in the usual sense of the word. Congress recognized that a capital gain, while realized in the year of sale, is, unlike ordinary net income, not earned during the taxable year, but, rather, is the result of gradual enhancement in the value of the property over a series of years. It was because of this difference that Congress accorded preferential treatment to capital net gains. See Committee Reports on the 1921 Revenue Bill (Appendix C, *infra,* pp. 40–43). See also *Burnet* v. *Harmel,* 287 U.S. 103. The taxing Acts generally take into consideration only the operations of the current year. The deductions al-

(N.D.Ill.), 5 F. Supp. 737, now pending after argument in the Circuit Court of Appeals for the Seventh Circuit; *White* v. *Atkins, supra.*

lowed under the statutes generally represent expenses paid or accrued on losses suffered during the same taxable year covered by the statute. Cf. *Woolford Realty Co.* v. *Rose*, 286 U.S. 319. And so it is with charitable contribution deductions. Congress apparently intended to allow a taxpayer to deduct contributions to the extent of 15% of his current income. But since a capital gain represents, not ordinary current income, but rather, unrealized earnings of prior years,[9] there appears to be no reason why the charitable deductions for one particular year should be measured by these unrealized earnings of prior years. Congress, itself, has made the distinction by giving capital net gains separate classification, and, we submit, the distinction should be preserved. Charitable deductions should be based on current income, that is, on the "ordinary net income." In any event, the argument appears to lose sight of the fact that while Congress may have intended to encourage charitable contributions, it also fixed a definite limit to the amount deductible. The argument begs the question, for the problem here is the extent of the express limitation. Moreover, this argument also loses sight of the doctrine that deductions are purely matters of legislative grace and are not allowable as of right.

[9] The property sold must have been held for more than two years before it is recognized as a capital asset. Section 101 (c) (8), *infra*, p. 30.

The Circuit Court of Appeals for the First Circuit in *White* v. *Atkins, supra,* following the suggestion of the Board in the *Straus* case, *supra,* made much of the placing of a comma in Section 101 (c) (7). It will be recalled that that section defines "ordinary net income" to mean "the net income, computed in accordance with the provisions of this title, *after excluding all items of capital gain, capital loss, and capital deductions.*" (Italics supplied.) It is said that because the phrase "computed in accordance with the provisions of this title" is set off by commas it must be taken to modify net income, which, as defined in Section 21, includes capital net gains. From this it is argued that "net income", as defined in Section 21, is first computed, and then, and thereafter, the capital items are eliminated in determining ordinary net income. But this contention ignores entirely the succeeding phrase of the section, which commands that the computation be made *after* excluding all capital items. See also p. 7, *supra.* In any event, the capital net gain provisions are to be considered in their entirety, and when so considered, we submit, they show a design to classify separately the two types of income. This purpose, running through all the provisions, cannot be affected by the mere placing of a comma in one of the subdivisions. Punctuation is no part of the statute in such circumstances. *Hammock* v. *Loan and Trust Co.,* 105 U.S. 77, 84. "In the construc-

tion of statutes the rules of grammar are less important than the intention of the legislature." *Singer Manuf'g. Co.* v. *M'Collock*, 24 Fed. 667, 668 (C.C., E.D.Ark.)

Both the court below, in the instant case, and the First Circuit, in the *Atkins* case, placed considerable reliance upon the alleged long-continued administrative construction of the statute, and relied upon the oft-cited rule that the reenactment of a statute without change should be taken as implied approval of previous administrative interpretation. For this interpretation the court below referred to a telegram sent by the Deputy Commissioner to a taxpayer under date of February 6, 1923. This telegram was never published. Reference is also made to I.T. 2104, III–2 Cumulative Bulletin 152. The latter ruling dealt with capital net losses. These earlier rulings did not represent the uninterrupted Treasury interpretation of the statute. Following the *Elkins* decision by the Board (the first decision on the question), the Commissioner accepted the Board's theory of segregation and published official rulings in accordance therewith. See Mim. 3931, XI–1 Cumulative Bulletin 33, Mim. 3986, XI–2 Cumulative Bulletin 29; G.C.M. 11324, XI–2 Cumulative Bulletin 267; I.T. 2668, XI–2 Cumulative Bulletin 268. Thus, following the *Elkins* decision, the Bureau's position has been entirely consistent with the position taken in this case. This position is also consistent with that taken by the Board in the *Livin-*

good, Harbison and *Colgate* cases, *supra*, and with that taken in the instant case. In none of these cases was the Board disturbed by earlier inconsistent Bureau practice. The *Elkins* decision was handed down November 3, 1931. Mim. 3931, XI–1 Cumulative Bulletin 33, *supra,* was published January 27, 1932, and it specifically held that the 15% limitation on the deduction for contributions shall be computed upon the basis of the taxpayer's net income, excluding capital net gain. The Revenue Act of 1932, c. 209, 47 Stat. 169, which reenacted without substantial change the capital net gain provisions here involved (Section 101), was not passed until June 6, 1932. It would seem more logical to say that Congress has impliedly approved the published decision of the Board in the *Elkins* case and the published ruling of January 27, 1932, than to say that it has impliedly approved the unpublished telegram relied upon by the court below. In any event, the earlier inconsistent Treasury rulings have no more force than the reasoning given to sustain them. *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 21.

We submit that the reasoning of the Board in the *Elkins, Harbison,* and *Colgate* cases, *supra,* and the reasoning of the dissenting opinion of Judge Learned Hand in the instant case and of Judge Morton in the *Atkins* case, *supra,* are to be preferred over the reasoning in the *Straus* and later cases.

As already set forth, if the decision below is sustained, it will mean that taxpayers who derive capital net gains and elect to be taxed under Section 101 (a) will not only receive the benefit of a lesser tax on their capital net gains, but will also have the benefit of including those self-same capital net gains in the computation of the ordinary net income deduction for contributions (that is, having the capital net gains added to the base for computing the 15% limitation on contributions), as though such election had not been made under Section 101 (a) of the Act.

We respectfully urge that in cases where Section 101 (a) is applied, the taxpayer's two classes of income must be completely segregated and the capital items must not enter into the computation of ordinary deductions.

CONCLUSION

It is respectfully submitted that the decision of the court below should be reversed.

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SEPTEMBER 1934.

APPENDIX A

Revenue Act of 1928, c. 852, 45 Stat. 791, 795, 796, 797, 799, 811:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax equal to the sum of the following:

[Here follows list of rates.]

SEC. 12. SURTAX ON INDIVIQUALS.

(a) *Rates of surtax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every individual a surtax as follows:

[Here follows list of rates.]

PART II.—COMPUTATION OF NET INCOME

SEC. 21. NET INCOME.

"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on

for gain or profit, or gains or profits and income derived from any source whatever.

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(n) *Charitable and other contributions.*—In the case of an individual, contributions or gifts made within the taxable year to or for the use of:

* * * * *

(2) any corporation, or trust, or community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes * * *;

* * * * *

to an amount which in all the above cases combined does not exceed 15 per centum of the taxpayer's net income as computed without the benefit of this subsection. * * *

* * * * *

SEC. 101. CAPITAL NET GAINS AND LOSSES.

(a) *Tax in case of capital net gain.*—In the case of any taxpayer, other than a corporation, who for any taxable year derives a capital net gain (as hereinafter defined in this section), there shall, at the election of the taxpayer, be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted and the total tax shall be this amount plus 12½ per centum of the capital net gain.

(b) *Tax in case of capital net loss.*—In the case of any taxpayer, other than a corporation, who for any taxable year sustains a capital net loss (as hereinafter defined in this section), there shall be levied, collected, and paid, in lieu of all other taxes imposed by this title, a tax determined as follows: a partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner as if this section had not been enacted, and the total tax shall be this amount minus 12½ per centum of the capital net loss; but in no case shall the tax of a taxpayer who has sustained a capital net loss be less than the tax computed without regard to the provisions of this section.

(c) *Definitions.*—For the purposes of this title—

(1) "Capital gain" means taxable gain from the sale or exchange of capital assets consummated after December 31, 1921.

(2) "Capital loss" means deductible loss resulting from the sale or exchange of capital assets.

(3) "Capital deductions" means such deductions as are allowed by section 23 for the purpose of computing net income, and are properly allocable to or chargeable against capital assets sold or exchanged during the taxable year.

(4) "Ordinary deductions" means the deductions allowed by section 23 other than capital losses and capital deductions.

(5) "Capital net gain" means the excess of the total amount of capital gain over the sum of (A) the capital deductions and capital losses, plus (B) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gains.

(6) "Capital net loss" means the excess of the sum of the capital losses plus the capital deductions over the total amount of capital gain.

(7) "Ordinary net income" means the net income, computed in accordance with the provisions of this title, after excluding all items of capital gain, capital loss, and capital deductions.

(8) "Capital assets" means property held by the taxpayer for more than two years* * *.

* * * * *

(d) *Collection and payment of tax.*—The total tax determined under subsection (a) or (b) shall be collected and paid in the same manner, at the same time, and subject to the same provisions of law, including penalties, as other taxes under this title.

Revenue Act of 1924, c. 234, 43 Stat. 253, 262:

SEC. 207. (b) If a fiscal year of a partnership begins in one calendar year and ends in another calendar year, and the law applicable to the second calendar year is different from the law applicable to the first calendar year, then (1) the rates for the calendar year during which such fiscal year begins shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling within such calendar year bears to the full fiscal year, and (2) the rates for the calendar year during which such fiscal year ends shall apply to an amount of each partner's share of such partnership net income (determined under the law applicable to such calendar year) equal to the proportion which the part of such fiscal year falling

within such calendar year bears to the full fiscal year. In such cases the part of such income subject to the rates in effect for the most recent calendar year shall be added to the other income of the taxpayer subject to such rates and the resulting amount shall be placed in the lower brackets of the rate schedule applicable to such year, and the part of such income subject to the rates in effect for the next preceding calendar year shall be placed in the next higher brackets of the rate schedule applicable to such year. (U.S.C., Title 26, Sec. 938.)

Treasury Department Regulations 74 (promulgated under the Revenue Act of 1928):

ART. 261. *Contributions or gifts by individuals.*—Contributions or gifts made within the taxable year by an individual are deductible to an aggregate amount not in excess of 15 percent of the taxpayer's net income (including such payments), if made to or for the use of:

[Here follow descriptions of donees.]

ART. 501. *Definition and illustration of capital net gain.*—Section 101, which applies to sales and exchanges of capital assets consummated after December 31, 1921, provides that any taxpayer other than a corporation may, if he so desires, state separately in his return his net gain on sales or exchanges of capital assets, and pay on such capital net gain (as defined and limited in the section) a tax of 12½ percent of the capital net gain in lieu of the tax he would otherwise pay on such income under sections 11, 12, 102, and 211. The tax upon his net income from other sources, termed "ordinary net income," is to be computed at the rates and in the manner provided in sections 11, 12, 102, and 211. The total tax will be the sum

of the tax upon the ordinary net income plus 12½ percent of the capital net gain.

* * * * *

"Capital gain" is taxable gain from the sale or exchange of capital assets consummated after December 31, 1921. "Capital loss" is deductible loss resulting from the sale or exchange of capital assets. See article 591 for the basis for determining such gain or loss, and article 561 as to adjustments for improvements, depreciation, and other items. "Capital deductions" are deductions properly allocable to or chargeable against capital assets sold or exchanged during the taxable year. "Capital net gain" is the excess of the total amount of capital gain over the sum of (1) capital deductions and capital losses, and (2) the amount, if any, by which the ordinary deductions exceed the gross income computed without including capital gain.

* * * * *

The credit for taxes allowed by section 131 (see articles 691–698) is a credit against the total tax, however computed, but the credits allowed by section 25 are allowed "for the purpose of the normal tax only" and may not be taken against capital net gain, although they may be deducted from "ordinary net income" in computing the amount of the tax.

* * * * *

ART. 502. *Returns of capital net gain.*— Segregation of transactions for the purposes of section 101 (a) is required only where the taxpayer elects to be taxed under that subdivision. When a taxpayer elects to be taxed under section 101 (a) for any taxable

year, he must attach to his return of income for such year an accurate statement under oath showing all items of capital gain, capital loss, and capital deductions in such manner as will clearly show the exact amount of his capital net gain for the taxable year. Each transaction must be separately shown and the capital items with respect thereto grouped together in order that the capital gain derived or the capital loss sustained from each capital transaction will readily appear. In the case of sales or exchanges of securities or any other property, the statement must show how long the property was held by the taxpayer immediately preceding the sale or exchange.

ART. 503. *Capital net losses.*—Section 101 (b) provides for the determination of the tax in the case of any taxpayer (other than a corporation, but including the members of a partnership, an estate or trust, or the beneficiaries thereof) who in any taxable year sustains a capital net loss. A "capital net loss" is the excess of the sum of the capital losses plus the capital deductions as defined in article 501, over the total amount of capital gain as therein defined. It is to be noted that, while the tax provided in section 101 (a) in the case of a capital net gain is to be imposed at the election of the taxpayer, the limitation with respect to a capital net loss provided in section 101 (b) will be applied irrespective of the taxpayer's election.

In the case of any taxpayer, other than a corporation, who sustains a capital net loss for any taxable year, there shall be levied, collected, and paid, in lieu of the normal tax and the surtax imposed by sections 11, 12, 102, and 211, a tax determined as follows:

A partial tax will first be computed upon the basis of the ordinary net income, as defined in section 101 (c) (7) and article 501, at the rates and in the manner provided in sections 11, 12, 102, and 211, and the total tax will be this amount minus 12½ percent of the capital net loss, but in no case shall the tax under section 101 (b) be less than the tax computed without regard to the provisions of section 101.

APPENDIX B

Hearing before the Committee on Ways and Means, 67th Cong., 1st Sess. (December 20, 1920), pp. 131–132, 133, 136:

> Mr. LONGWORTH. Your theory is that the sale of capital assets and the profits resulting therefrom is not the same as the ordinary course of business which produces a profit?
>
> Mr. KELLOGG. That theory is recognized in England, and, I believe, in Canada, today. They have no such tax in England.
>
> * * * * *
>
> Mr. KELLOGG. You have seen what I was going to suggest as one thing subject to the approval of the committee as a way of dealing with this situation, *that all of those things should be segregated into one item and subjected to a flat tax.* You have foreseen exactly what was in my mind.
>
> Mr. LONGWORTH. I have thought a good deal along those lines.
>
> * * * * *
>
> Mr. LONGWORTH. It would be conceivable to my mind that a tax as low as 10 or 15 percent would raise more revenue on these transactions than we are getting now, simply from your statement, which is corroborated in many quarters.
>
> * * * * *
>
> Mr. GREEN. If we would put it on a percentage basis, however, in many cases it would be altogether too high, because it

would operate simply as a sales tax. In other cases it would be too low.

Mr. KELLOGG. *It would not if you adopt the suggestion that Mr. Longworth and I were mentioning a moment ago—if you segregated all those things,* whether they amounted to $1,000 profit or $1,000,000 profit, and fixed a flat percentage of that particular profit as the tax which should be payable by the taxpayer.

* * * * *

Mr. KELLOGG. I would do that in this way: *I would make a segregated flat tax on the amount of profits derived from the transactions*—only make it just as low as your experience and your technical advisers think it is proper to make it, because the lower you make it the more transactions you will encourage. That is the only thing I would suggest. (Italics supplied.)

Internal-Revenue Hearings before the Committee on Finance, United States Senate, 67th Cong., 1st Sess. (May 9–27, 1921), on the Proposed Revenue Act of 1921, pp. 539, 544:

Mr. KELLOGG. * * *

* * * I ask this committee to consider what I have called the *segregation* plan * * *.

Fix a time which seems to you reasonable as *distinguishing between ordinary transactions and real investment transactions.* It seems to me a short time is ample for that—six months, for instance, but call it a year—* * * if a man has held property for more than a year and sells or exchanges it, that shall be called *an extraordinary transaction or a capital transaction, or whatever name you please to give it, so long as it is segregated. Put that transaction in*

one column and put any other similar transaction in the same column. Do not subject it to the normal tax or surtax, but a *flat tax.* * * *. I do not think it ought to be more than 10 percent at the outside. * * * *Make everybody pay identically the same tax on the same class of transactions. Put all the rest of your income into the general return, and add this 10-percent tax on this special transaction to the total amount derived from the other taxation branches of income,* and the total will represent the tax obligations to the Federal Government for that taxable year. (Italics supplied.) (Page 544.)

Mr. KELLOGG. * * *

* * * * *

The subject I am discussing, Senator Calder, is the subject of the sale of capital proceeds and the sale of capital assets, and I have attempted to maintain the thesis that those transactions should be *segregated from general taxation* and subjected to a flat tax of not more than 10 percent. (Italics supplied.)

Hearings before the Committee on Finance, United States Senate, 67th Cong., 1st Sess. on H.R. 8245 (Revenue Bill of 1921) September 1–October 1, 1921, pp. 36–37:

Dr. ADAMS. This section 207 was adopted by the House in the belief that a great many important transactions in the way of the sale of capital assets are now being held up or blocked by the heavy rates of taxation. You will see the effect of it by an illustration. For instance, if a man buys a farm and holds it for 8 years, and it increases in value, and he sells it, all the gain is treated or taxed as of that one year, although in one sense of

the word it was accruing during the 8 years that he held it. Still, in that one year his gain puts him in the high surtax class. Under this section a capital gain will be taxed only at the same rate as is applied to corporations, namely, 12½ percent. That is the theory of the section. * * *

* * * * *

Senator SMOOT. Do I understand that if it is an individual all he has to pay is the 12½ percent corporation tax, and over and above that do you exempt him from paying an income tax?

Dr. ADAMS. You simply *set aside from his ordinary income this capital income*, and the rate on the capital income is limited to 12½ percent. The same limit is placed on losses.

Senator SMOOT. That is to say, he makes $10,000 profit on the sale of the house; and upon the $10,000 he pays 12½ percent and no other tax?

Dr. ADAMS. And no other tax.

Take this illustration: Suppose a man has an ordinary income of $20,000 a year. He sells a farm and makes $80,000. That would give him an income for that year of $100,000. Under existing law he would pay about 30 percent, on the average, on that. What is proposed is this: *Have him set $20,000, his regular income, aside.* That is put *in one class.* Have him *set $80,000 aside in another class. Then compute the tax on the ordinary income of $20,000 in the usual way,* and on the $80,000 he would also pay 12½ percent. (Italics supplied.)

APPENDIX C

Legislative history of the capital net gain provisions, being the pertinent parts of the 1921 Revenue Bill in its various forms [10] and the Committee Reports thereon:

Section 206 (b) of the House bill was as follows:

> In the case of any taxpayer (other than a corporation) whose ordinary net income and capital net gain together exceed $29,000, there shall be levied, collected, and paid, in lieu of the taxes imposed by sections 210 and 211 of this title, a tax determined as follows:
>
> A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain, or minus 12½ per centum of the capital net loss, as the case may be; but in no such case where the taxpayer derives a capital net gain, shall the total tax be less than 12½ per centum of the total net income. The total tax thus determined shall be levied, collected, and paid at the same time and in the same manner and subject to the same provisions of law, including penalties, as other taxes under this title.

[10] The pertinent parts of the Bill in its various forms are taken from the Conference Print on H.R. 8245 (Revenue Bill of 1921), 67th Cong., 1st Sess., pp. 22–23.

The House Ways and Means Committee report on the Bill was as follows (H. Rep. No. 350, 67th Cong., 1st Sess., pp. 10–11):

> SECTION 206. The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. Many such sales, with their possible profit taking and consequent increase of the tax revenue, have been blocked by this feature of the present law. In order to permit such transactions to go forward without fear of a prohibitive tax, the proposed bill, in section 206, adds a new section (207) to the income tax, providing that where the net gain derived from the sale or other disposition of capital assets would, under the ordinary procedure, be subjected to an income tax in excess of 15 percent, the tax upon capital net gain shall be limited to that rate. It is believed that the passage of this provision would materially increase the revenue, not only because it would stimulate profit-taking transactions but because the limitation of 15 percent is also applied to capital losses. Under present conditions there are likely to be more losses than gains.

The Senate Bill was as follows:

> SEC. 206 (b). In the case of any taxpayer who for any taxable year derives a capital net gain, such capital net gain shall, under regulations prescribed by the Commissioner with the approval of the Secretary, *be stated separately from the ordinary net income in the taxpayer's return;* and only 40 per centum of such capital net gain shall be taken

into account in determining the amount of the net income upon which taxes are imposed by sections 210, 211, and 230 of this title. (Italics supplied.)

The Senate Finance Committee Report was as follows (S. Rep. No. 275, 67th Cong., 1st Sess., pp. 12–13):

Section 206 limits the rate of taxation upon gain derived from the sale of capital assets. Under the present law many sales of farms, mineral properties, and other capital assets have been prevented by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum and the amount of surtax excessively enhanced thereby. In order to permit such transactions to take place without fear of prohibitive tax, section 206 provides that only 40 percent of the net gain derived from the sale or other disposition of capital assets shall be taken into account in determining the net income upon which the income tax is imposed. This automatically reduces the rate of taxes applicable to such income by 60 percent. The maximum rate (normal and surtax) upon ordinary income after January 1, 1922, will be 40 percent, and the maximum rate applicable to capital net gain will be 16 percent. The House bill placed a similar limitation upon both capital gains and losses, but this limitation was not applicable to corporations nor to certain classes of taxpayers having net income less than $29,000. The Senate provision would permit a taxpayer to deduct the entire loss sustained in a capital transaction and is applicable to all classes of taxpayers. In Great Britain capital gain or loss is ignored or eliminated in computing the net income.

> Section 206 takes an intermediate position between the extreme views embodied, respectively, in the present American and British laws.

The Bill as agreed upon in conference was as follows:

> (B) In the case of any taxpayer (other than a corporation) who for any taxable year derives a capital net gain, there shall (at the election of the taxpayer) be levied, collected and paid, in lieu of the taxes imposed by sections 210 and 211 of this Title, a tax determined as follows:
>
> A partial tax shall first be computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and the total tax shall be this amount plus 12½ per centum of the capital net gain; but if the taxpayer elects to be taxed under this section the total tax shall in no such case be less than 12½ per centum of the total net income. The total tax thus determined shall be computed, collected and paid in the same manner, at the same time and subject to the same provisions of law, including penalties, as other taxes under this title.

The Conference Report was as follows (H. Conference Rep. No. 486, 67th Cong., 1st Sess., p. 20):

> The House bill limited the tax to 12½ percent upon capital net gain and similarly limited the deduction allowance for capital net loss in the case of any taxpayer (other than a corporation) whose ordinary net income and capital net gain together exceed $29,000. Senate amendment 115 changes the House method of limiting the tax upon capital net gain, eliminates all reference to capital net loss, and makes this provision applicable to

all taxpayers (including corporations) who for any taxable year derive a capital net gain. The House recedes with an amendment providing that in the case of any taxpayer (other than a corporation) who for any year derives a capital net gain there shall (at the election of the taxpayer) be collected, in lieu of the taxes imposed by sections 210 and 211, a tax consisting of the sum of (1) a partial tax computed upon the basis of the ordinary net income at the rates and in the manner provided in sections 210 and 211, and (2) 12½ percent of the capital net gain; but if the taxpayer elects to be taxed under this section, the total tax shall in no such case be less than 12½ percent of the total net income.

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